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**NICARAGUA**

**SUPPORT OF THE PENSION SYSTEM REFORM**

**PROJECT NO.: NI-0101**  
**LOAN NO. 1089/SF-NI**

**LOAN PROPOSAL**  
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## **BASIC SOCIOECONOMIC DATA**

The basic socioeconomic data for Nicaragua available on the Internet at the following address:

**English:**

[www.iadb.org/int/sta/english/staweb/](http://www.iadb.org/int/sta/english/staweb/)

**Spanish:**

[www.iadb.org/int/sta/spanish/staweb/](http://www.iadb.org/int/sta/spanish/staweb/)

## **INFORMATION AVAILABLE IN THE FILES OF RE2/F12**

### **PREPARATION:**

Pension System Law, Law 340

Pension Superintendence Law, Law 388

Implementation legislation, Decreto Ley 32-2000; 55-2000; 56-2000; 57-2000

Consultant reports, various - Julio Bustamante, 1998/1999

Report Abstract: Actuary Valuations, 12/1998

Report Abstract: Recognition Bonds' design and valuation

### **EXECUTION:**

## ABBREVIATIONS

BCN	Banco Central de Nicaragua
BOMEX	Bonos Moneda Extranjera
BPI	Compensation Bonds
CBT	Certificado Bonos del Tesoro
CENIS	Certificados Negociables de Inversión
CENIVAL	Central Nicaragüense de Valores
DC	Defined contribution system
EAP	Economic active population
E&M	Enfermedad y Maternidad
FSO	Fund for Special Operations
GDP	Gross domestic product
GON	Government of Nicaragua
HIPC	Highly Indebted Poor Countries
ILO	International Labor Organization
IMF	International Monetary Fund
INISER	Instituto Nicaragüense de Seguro y Reaseguro
INSS	Instituto Nicaragüense de Seguridad Social
IPD	Implicit Pension Debt
IVM	Invalidez, Vejez y Muerte - Old Age, Disability, Survivor Benefit
KPMG	Accounting and Auditing Firm
MIF	Multilateral Investment Fund
NIR	Net International Reserves
OECD	Organization for Economic Corporation and Development
OVE	Office of Oversight and Evaluation
PAYG	Pay-as-you-go
PFA	Pension Fund Administrator
PRGF	Poverty Reduction and Growth Facility
ROI	Return on Investment
RP	Riesgos Profesionales
SBIF	Superintendencia de Bancos y Otras Instituciones Financieras
SETEC	Secretaría Técnica de la Presidencia de la República

## Support of the Pension System Reform

(NI-0101)

### EXECUTIVE SUMMARY

<b>Borrower:</b>	Republic of Nicaragua		
<b>Executing agency:</b>	Technical Secretariat of the Presidency of the Republic		
<b>Amount and Source:</b>	IDB: (FSO)	US\$	30 million
	Total:	US\$	30 million
<b>Financial terms and conditions:</b>	Amortization Period:	40	Years
	Grace Period:	10	Years
	Disbursement Period:	18	Months
	Interest Rate:	variable	
	Supervision and Inspection:	1.0	%
	Credit Fee:	0.5	%
	Currency:		
<b>Objectives:</b>	The objective of the proposed operation is to support the Nicaraguan Government's reform of the country's mandatory pay-as-you-go pension system (PAYG), which is aimed at containing the fiscal costs of the present scheme and the establishment of a financially sustainable DC system.		
<b>Description:</b>	<p>The proposed operation is designed to support the structural reform of the pension sector and provide financing within the context of the Government's Poverty Reduction and Growth Facility (PRGF) agreement with the International Monetary Fund (IMF).</p> <p>The program is structured as a fast-disbursing operation with two disbursements: the first disbursement of up to US\$20 million, and the second of up to US\$10 million.</p> <p>The program entails a set of measures and actions to be taken, which comprise fundamental elements of the reform policy of Government for the pension sector and will facilitate the development of an adequate legal, regulatory and institutional framework for the implementation of private services providers.</p> <p>Disbursements of program resources would be conditioned on satisfactory compliance with stipulated reform and policy actions. Five principal areas of reform efforts are proposed: (i) establishment of the legal framework for the new system, (ii) implementation of the parametric reform of the current defined benefit PAYG system, (iii) establishment of the institutional arrangements for supervision and service provision; (iv) establishment of a financing plan for transition costs; and (v) initiation of implementation process.</p>		
<b>Bank's country and sector strategy:</b>	The proposed operation is consistent with the Bank's strategy to support economic development and poverty reduction and the reduction of inequalities, within the context of a stable macro economic framework and increasing private sector participation in the provision of goods and services. The proposed operation marks the continuation of Bank support for Government of Nicaragua		

(GON) efforts to modernize the state, advance structural reforms and, specifically, develop and strengthen the country's financial sector and capital markets. The proposed operation reflects the lessons drawn from earlier reform programs being structured around a reduced number of clearly identified design and implementation benchmarks, compliance of which can be measured in a transparent way.

The preparation of the present operation and its design has been closely coordinated with the World Bank and the International Monetary Fund. Technical work in the definition and design of reform elements has been supported by a technical cooperation grant from the Multilateral Investment Fund, as well as a technical assistance loan from the World Bank.

**Environmental/  
Social review:**

The Committee on Environment and Social Impact approved the operation without observations. The operation is not expected to have negative social or environmental impact.

**Benefits:**

The operation would assist the Government of Nicaragua in implementing a far-reaching structural reform of the Pension System, thereby avoiding a further increase in the implicit fiscal costs of the present arrangement and subsequent macro economic distortions and inequalities. Containing the fiscal costs of the public provision of pension benefits will eliminate inter- and intra-generational inequalities, including the income transfer toward the higher income segments of society, as well as strengthen the macro economic framework. The reform will reduce labor market distortion, in as much as it will provided for the sustainable financing of meaningful old age benefits for system participants. Private sector administration of the system, within the framework of adequate regulation, will increase its transparency and credibility, and the availability of long-term resources will contribute to the development of the domestic financial markets.

**Risks:**

The proposed operation by itself does not face major risks for its execution and the disbursement of resources. A broad social consensus regarding the reform has been established, with all sectors agreeing on its importance and main elements. Moreover, Government and Parliament have moved decisively in approving the required legal framework for the defined contribution system and the parametric reforms have been enacted.

The successful implementation of the reform faces a number of risks. Successful reform implementation will need to overcome a legacy of "absenteeism" with regards to the social security system in general and pension provision in particular. Increasing the coverage ratio through increased public awareness and improved enforcement will help to increase the volume of total pension funds under administration and thereby decrease the risks deriving from the comparatively small market. However, guaranteeing an adequate level of competition will remain a challenge for the reform. Given experiences in other reform countries the industry will likely be dominated by few service providers. Authorities will need to create a level playing field for all potential providers, specifically during the system's initiation. A second market risk results from the relatively incipient development of Nicaragua's financial sector, both in terms of depth and institutional strength. Lack of market depth could affect the diversification options for Pension Fund Administration (PFA) and the resulting risk profile. GON intends to mitigate those risks by allowing PFA from the outset to invest a portion of funds in the international capital markets. In the



short term some political risk might result from the national elections scheduled for November 2001 with resulting uncertainty influencing the speed of implementation of the system.

**Special contractual clauses:**

Disbursement of program resources will be subject to the conditions presented in the Policy Matrix in Annex I.

**Poverty-targeting and social sector classification:**

The proposed operation qualifies as a social equity enhancing (SEQ) project, as described in the indicative targets mandated by the Bank's Eighth Replenishment.

**Exceptions to Bank policy:**

None

**Procurement:**

Fast-disbursing resources from the program will be used to finance the costs of eligible imports from the Bank's member countries. The Bank's simplified procedure for sector loans shall apply, eliminating the requirement for international bidding.

## I. BACKGROUND

### A. Overview

- 1.1 The Government of Nicaragua (GON) has requested the Bank's support for a sector reform and macroeconomic stabilization program anchored in a Poverty Reduction and Growth Facility (PRGF) agreement with the International Monetary Fund (IMF) approved in March 1998. In the context of the agreed macroeconomic program GON aims to further stabilize the macroeconomic situation through a reduction of the fiscal deficit, an increase in international reserves and a program of structural reforms designed to eliminate sources of rigidities and distortions which hinder private sector led economic growth.
- 1.2 The proposed operation supports the Government of Nicaragua in the reform of the country's pension system and its transformation from a government administered Defined Benefit scheme to a privately operated, fully funded Defined-Contribution system. The reform is directed at establishing the new system, while reducing the fiscal costs of the current scheme and during the transition. The implementation of the reform should also help to reduce labor market distortions, deepen the financial markets and enhance macroeconomic stability in the long term. The Bank and the World Bank have been supporting the reform process, which is also an element of the IMF program with Nicaragua.

### B. The context of the Program

- 1.3 *Nicaragua has advanced substantially over the last decade in stabilizing its macro economic situation and implementing structural reforms, allowing important growth rates during the second half of the decade. However, though the country reached the Highly Indebted Poor Countries (HIPC) Decision Point at the end of 2000, recent performance of the macro economic program has evidenced the need for policy adjustments to avoid growing imbalances going forward. Although financial sector legislation has been strengthened the sector has shown strains in 2000 and early 2001, leading to the closure of institutions. Capital market development is recent and the sector offers still only limited diversification options, although volume has grown steadily and should allow for accommodation of addition resources.*
- 1.4 **Macroeconomic Development.** Over the last decade Nicaragua has made significant progress in the area of stabilization and structural reform. Following the change of government in 1990, fiscal and monetary policies were strengthened, direct interventions in factor markets and price controls eliminated and the foreign exchange and trade system liberalized. Furthermore, to increase private sector participation in the economy the investment regime and regulatory framework was strengthened and the state reduced its role in the provision of goods and services. Numerous state companies were liquidated or divested since the early 1990's, substantially increasing the role of the private sector in the economy. Government has initiated a process of privatization and granting of

licenses for provision of infrastructure services, especially in the area of telecommunication and energy services, which will further increase the private sector share of GDP.

- 1.5 The improved macro economic conditions and structural reforms allowed for significant GDP growth over the decade, averaging 5% p.a. since 1995, despite the adverse effects of Hurricane Mitch in 1998. Enhanced monetary and fiscal policies significantly reduced the imbalances observed during the previous decade, allowing for the sustained deceleration of the country's inflation rate. Following the hyperinflationary period of 1989 – 1991, the rate declined to 24% in 1992 and further to 10% by the end of the decade. Current projections estimate a single digit rate for the next years. In line with the diminished inflationary expectation the exchange rate policy was changed in 1999, reducing the rate of the crawling peg from 12% to 6% annually.
- 1.6 The Bank, the World Bank and the IMF, as well as bilateral donors have supported Nicaragua's stabilization and reform efforts, through a number of adjustment operations and investment programs. Furthermore, Nicaragua has been declared eligible for debt relief under the HIPC initiative and it reached the HIPC Decision Point at the end of December 2000.
- 1.7 Since 1998, GON has been implementing an IMF-supported three-year economic program under the Poverty Reduction and Growth Facility (PRGF). Performance under the program was satisfactory initially, but increased fiscal and external balances led to slippage, especially toward the end of 2000, and to the revision of second year benchmarks. Moreover, the costs of the intervention and liquidation of three commercial banks over the last nine months have put additional strains on the fiscal and monetary aggregates, as has the relative lack of fiscal restraint in the wake of the municipal elections.
- 1.8 GDP growth in 2000 is estimated at 4.1%, compared to a target of 5%. The fiscal deficit increased to approximately 15% of GDP, substantially exceeding the revised target of 13.6% and more than double the initial projections; and Net International Reserves (NIR) contracted by US\$30 million, compared to an expected increase of US\$60 million. This was mainly due to some capital flight in the wake of the banking problems and delays in the disbursement of the Multilaterals' resources.
- 1.9 Currently, GON and IMF authorities are negotiating the third year program under the PRGF. Important elements of the program are the need to reduce fiscal imbalances and reverse the substantial loss of NIR. Structural performance benchmarks of the program will include measures in the financial system, the reform of the pension system and progress in the privatization of the public utilities. However, program implementation will need to accommodate the anticipated costs of the banking resolution and a likely deceleration of GDP growth, as well as uncertainty in the wake of the presidential elections late 2001.

Negotiations are substantially advanced and an agreement in principal is expected during the second quarter.

- 1.10 The table below provides a summary of selected economic and financial indicators for the five-year period 1997 – 2001.

**Table I-1**  
**Select Economic and Financial Indicators – 1997 -2001**

Concept	1997	1998	1999	2000	2001
	(annual percentage change unless otherwise specified)				
GDP	5.1	4.1	7.4	4.3	3.0
GDP per capita	2.3	1.3	4.5	1.5	...
CPI (end period)	7.3	18.5	7.2	9.9	8.0
Unemployment (%)	14.3	13.2	10.7	9.8	...
Bank deposits	56.6	28.6	23.2	4.8	6.0
Credit to private sector	39.8	45.3	39.9	14.2	6.2
Fiscal Deficit (% of GDP) <sup>1)</sup>	- 7.3	- 3.0	- 12.5	- 13.6	- 12.0
NIR (million US\$)	144.2	138.5	216.1	186.7	...
External Debt (million US\$)	6,001.0	6,287.1	6,548.9	6,659.9	...

<sup>1)</sup> Before grants.

Source: BCN, IMF

- 1.11 **Labor Market.** Macroeconomic stabilization and structural reform also improved conditions in the labor market. The open unemployment rate, which peaked at over 20% in 1992, has declined steadily and according to GON figures reached approximately 10% in 2000. Furthermore, although still remaining high, the proportion of the labor force employed in semi-formal and informal arrangements has declined during the 1990's. Thus, the percentage of workers identifying themselves as self-employed declined from 35% in 1993 to 28% in 1998, whereas the proportion of workers employed in formal firms, i.e. those companies employing more than five salaried workers, increased from 18% to 35% during the same period.<sup>1</sup> However, underreporting and evasion is considerable, even among more formal businesses, and employment conditions remain precarious for an important segment of the labor force, especially in the rural areas.

<sup>1</sup> The International Labor Organization (ILO) definition of "formality" is used here, which relates to the business conduct and processes of companies, using employment size as proxy, and not to legal formality.

- 1.12 Employment pressure will rise inevitably over the next years, as the young population enters the labor market. Presently, close to half of Nicaragua's 5 million population is under the age of 15 and the unemployment rate for the young age group, i.e. 15 – 24 years old, is 1.3 times the rate for prime-age workers. In addition, female participation in the work force remains low, accounting only for about one third of employment. This raises the potential for added pressure on the employment situation, through the increased permanent incorporation of women in the labor market.
- 1.13 ***Financial Sector.*** The country's financial sector, which was re-privatized in the early 1990's, remains incipient and comparatively shallow, with commercial banks dominating the supply of services. The ownership and governance structure of the sector conforms to a "financial group model" whereby an investor group offers various financial services through different specialized companies. This approach is driven in part by the sector's legislation, which mandates some specialization in the supply of services, and regulatory arbitrage. Generally the "groups" are centered on a commercial bank and comprise investments in other non-bank financial service providers, as well as insurance business and brokerage services. Furthermore, in the three dominating groups domestic activities are complemented by investments in financial services' providers within the region. Direct foreign investment in the sector has been limited so far. Central American investors have taken minority stakes in two commercial banks and a group of international investors has acquired in 2000 a majority interest in a specialized micro-finance finance company.
- 1.14 In the banking sector there are currently seven private institutions operating, down from thirteen at the beginning of 2000. The sector's total assets at the end of 2000 were approximately US\$1,900 million; 57% of which corresponded to outstanding loans, 19% to liquid funds, including reserve requirements<sup>2</sup>, and investments, 9% accounts receivable and 6% other assets. Liabilities totaled US\$1,680 million, of which US\$1,416 million were deposits. The sector's assets and liabilities are essentially dollarized; with approximately 70% of liabilities being denominated in US-dollars and most of the rest in national currency indexed to the US-dollar. Equally, loans are generally denominated in US-dollars or indexed to this currency.
- 1.15 Supported by Bank operations progress has been made in improving the legislative and regulatory framework of the financial sector. Following the introduction of banking supervision and prudential norms in the early 1990s, in late 1999 Parliament passed a new General Banking law, a Bank Superintendence law, as well as a Central Bank law. Furthermore, Prudential Norms were improved, specifically with regard to capital adequacy standards, asset classification rules and loan loss provisions. Nonetheless, the sector showed considerable strains in 1999 and 2000, reflecting the weakness of supervision and

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<sup>2</sup> Reserve requirements are currently 16.25% for domestic and US-dollar deposits. They account for 11% of all assets of the banking sector.

lack of strong enforcement of the Prudential Norms during most of the 1990, coupled with excessive risk taking by financial institutions. During the second semester of 2000 two banks were closed and in early March 2001 a third institution was intervened and sold. The total costs of the banks resolutions still can not be assessed, but at present they are estimated to exceed US\$140 million, or 5.5% of GDP, and will likely increase. Following the recent consolidation process, prudential norm compliance has improved and the system's overall capital adequacy ratio is 14.1%, exceeding the required minimum of 10%. All banks have recently been or will be over the next month subject to special inspections by the Superintendence of Banks with the assistance of international inspection experts, in an effort to enhance compliance with Prudential Norms and further train Nicaraguan bank inspectors.

- 1.16 Non-bank financial intermediaries have developed slowly over the last decade, mainly as finance companies, in the bonded warehouse sector and in the area of leasing. Total assets of this sub-set at the end of 2000 are estimated at US\$7 million, 75% of which correspond to finance companies. As in the banking sector dollar-denominated or indexed assets and liabilities predominate.
- 1.17 The insurance sector also has been opened for private capital during the 1990's and private domestic providers initiated services at the end 1996. Furthermore, a number of international insurance businesses offer their services through registered representative brokers. However, the market remains dominated by the state-owned provider Instituto Nicaragüense de Seguro y Reaseguro (INISER), which has a market share of approximately 60%, with the rest divided between four private companies. Premium volume for 2000 was US\$50 million and the sector's outstanding contract volume reached US\$10,919 million at the end of the year. Property insurance constitutes the main product, followed by private health insurance and life insurance. The latter has increased its market participation in recent years, accounting for 22.9% of outstanding contracts at the end of 2000. Annuity contracts are still very rare in the Nicaraguan market, given the low level of demand for this type of product. However, it is expected that this segment will develop more strongly, once the pension reform is implemented, supported also by the introduction of complementary regulation for the sector by the Banking Superintendence.
- 1.18 To promote capital market development, a Stock Exchange was established in 1994. Market development was further fostered through the implementation of modern clearance and settlement arrangements, which are handled by the *Central Nicaragüense de Valores* (CENIVAL). In addition, the Superintendence in 1998 created a specialized section for oversight of the capital market and GON is currently drafting new capital market legislation, which will incorporate relevant international best practice. The aforementioned institutional arrangements should provide for a platform for future market development.
- 1.19 The presence of the Exchange did not lead to the rapid development of an "equity culture" and currently only debt titles are traded. Total trading volume in 2000

reached US\$800 million, of which less than 4.5% corresponded to primary or secondary market activities, and the rest to Repurchase and other similar operations. The bulk of trading is in Government/Central Bank debt obligations, which in 2000 accounted for 93% of trading volume, somewhat higher than the historical average of 85%. The first private titles were issued in 1995, consisting entirely of short-term fixed rate commercial paper and debt certificates. During 2000 no private issues were brought to market and only eight previously issued instruments were traded. Total volume of issued private and public instruments was estimated at US\$375 million at the end of 2000, excluding Compensation Bonds (BPI), which issued volume exceeded US\$600 million.<sup>3</sup> Moreover, the Superintendence of Banks, through its Capital Market Intendence, had authorized additional series of private debt with a volume of up to US\$29 million and the *Ministerio de Hacienda y Crédito Público* was authorized to issue up to US\$214 million in additional BPI. Overall, the majority of issues in the market are in national currency, indexed to the US-dollar, reflecting the predominance of public debt issues, specifically the Central Bank's *Certificados Negociables de Inversión* (CENIS) and BPI. However, private sector debt issues are mostly dollar-denominated. At year's end 85.4% of the outstanding volume corresponded to US-dollar titles.

- 1.20 Reflecting the prevalence of option and repo instruments, short-term operations by far dominate the market, with almost 58% having a 7-day term. Only 13.3% of all trades during 2000 were for over 360 days. Interest rates fluctuated considerably during 2000, both for domestic currency and US-dollar denominated instruments. Average interest rates for national currency instruments with a term of 7 to 360 days for the year were between 11.43% and 13.87%, whereas US-dollar denominated instruments yielded between 10.06% and 9.95%, although the thin trading volume in certain instruments distorts the data.
- 1.21 The limited number, volume and types of instruments currently issued and negotiated in Nicaragua's capital market likely pose a limitation to the diversification options for institutional investors, such as pension funds. Furthermore, lack of liquidity in certain instruments could hamper the timely execution of investment strategies. However, the market has shown a gradual increase in the number of issues and trading volume. Given the anticipated volume of pension fund flows the market should be in a position to absorb the added liquidity. As of end December 2000 total face value of outstanding and authorized debt issues was over US\$520 million, which compares to expected fund flows of less than US\$50 million over the first years.<sup>4</sup> The reduced fund flow

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<sup>3</sup> Bonos de Indemnización del Gobierno de Nicaragua (BPI) are compensation bonds for assets expropriated between 1979 and April 1990. Initially structured as Zero Coupon bonds with a 15 year term, they currently carry semi-annual coupon and an interest rate between 3% and 5% p.a. The first series of BPI was issued in 1993. Currently, the bonds trade at a discount of 50% to 80%, depending on term to maturity and size of title. Reportedly, approximately US\$200 million (at face value) are held by domestic financial institutions. International investors are retaining a substantial portion of the rest.

<sup>4</sup> The comparison assumes that all resources would be invested in public or private debt papers and none in other investment vehicles such as bank term deposits or international investments.

during the initial phase of the reform added to the availability of long term resources should provide for an opportunity for parallel market growth, thereby increasing diversification options and reducing the reform's impact on market liquidity.

- 1.22 The following table provides an overview of the stock of selected financial assets in Nicaragua's financial markets at the end of 2000.

**Table I-2**

**Stock of Selected Financial Assets December 2000**

Concept	US\$ million
<b>Bank deposits</b>	<b>1,449.9</b>
* Term Deposits	673.7
<b>Public Debt issues</b>	<b>520.7</b>
* CENIS (local currency)	227.0
* BOMEX (US-dollar)	49.3
* BPI (local currency), placed	200.0 <sup>1)</sup>
* BPI (local currency), authorized	42.2 <sup>2)</sup>
* CBT (local currency)	2.2
<b>Private Debt issues</b>	<b>46.6</b>
* placed series	17.5
* authorized series	29.1

<sup>1)</sup> Estimated 66% discount to face value, based on average term to maturity; <sup>2)</sup> Estimated 80% discount for maximum term; US\$ conversion at average exchange rate for 2000.

Source: SBIF, BCN, Nicaragua Stock Exchange reports, own calculation

**C. Bank strategy and justification**

- 1.23 The Bank's strategy, as outlined in the Nicaragua Country Paper of November 1999, emphasizes the objectives of poverty reduction and the reduction of inequalities, within the context of a stable macro economic framework and increasing private sector participation in the provision of goods and services. Although in the short term the pension reform will manifest the fiscal costs of the current pay as you go (PAYG) system and, depending on the financing options elected, could require to divert scarce resources toward covering the implicit pension debt (IPD), in the long term the reform will contribute towards realizing these objectives.



- 1.24 The proposed operation marks the continuation of Bank support for GON efforts to develop and strengthen the country's financial sector and capital markets. Since 1992, the Bank has approved various operations to assist in the creation of a legal and regulatory framework for the financial sector and the establishment of a private sector offer. In 1998 the Bank approved a financial sector loan in support of the Third Financial Sector Reform Program<sup>5</sup>. The operation's main objectives were to support the further modernization and strengthening of the banking system and the elimination of direct Government ownership and operation of commercial banks. The program provided for the implementation of new financial legislation, the strengthening of Prudential Norms and the divestiture or closure of state banks. Compliance with policy conditions of the loan has been progressing satisfactorily, although the recent bank interventions delayed disbursement actions. Currently, GON and the Bank are preparing the second disbursement of program resources and it is expected that the final disbursement will also take place during the course of the year.
- 1.25 Furthermore, in the fall of 1998 Multilateral Investment Fund (MIF) approved a capital markets modernization program,<sup>6</sup> which aims at: (a) legal reform, (b) strengthening of supervision capacity, and (c) modernization of clearance and settlement systems. Execution initiated in late 1999 following the naming of the sector Intendent.

#### **D. Bank experience and lessons learned**

- 1.26 Support of pension reform initiatives has been an area of comparatively limited activity by the Bank so far. Only a reduced number of operations have dealt with the issue directly, either through technical cooperation measures or a sector loan, or combination of both. Usually Bank activities have supported specific elements of reforms, like the modernization of the defined benefit systems and the partial introduction of a parallel privately funded "pillar". In light of this, no conclusive lessons can be drawn from the Bank's operational experience. Furthermore, by contrast to earlier operations, the proposed program would represent the first time that the Bank assists in a wholesale reform of a pension system, aimed at the almost complete phasing-out of public pension provision and moving towards a "one pillar" private system. However, ever since Chile undertook its reforms in 1981, followed by a number of countries in Latin America using a comparable approach<sup>7</sup>, a growing body of research and documentation has accompanied sector reform efforts in the region and beyond. This has allowed for the emergence of a general consensus on key issues of the reforms, including the rational itself of any reform, and the development of certain Best Practice considerations for their design.

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<sup>5</sup> Loan 1014/SF-NI

<sup>6</sup> ATN/MT-6157-NI

<sup>7</sup> Peru (1993), Colombia (1994), Argentina (1994), Uruguay (1996), Mexico (1997), Bolivia (1997) and El Salvador (1998) have all carried out reforms, partially inspired by the Chilean experience and practice. As is the case in Chile in all those reforms public pension provision is, at least for time being, complemented by a newly created privately finance "pillar".

- 1.27 Given the limited size of markets in many of the reform countries, increasingly consideration has been given to the constraints faced by pension reform initiatives in small developing countries. Policy recommendations primarily focus on design choices to ensure adequate levels of competition, reduce the system costs, minimize collusion and conflict of interests and improve investment choice for pension funds. Specific recommendations include that reforms should: (i) maximize the importation of services, up to the point of opening the market entirely for international and not domestically based services providers; (ii) allow for the unbundling and subcontracting of services, and eventually even mandate the unbundling of certain services to avoid natural monopolies; (iii) permit international diversification of the portfolio through investments in appropriately rated offshore securities, including mandating such investments on a decreasing scale for some time; and (iv) avoid regulations hampering price competition in the supply of pension services. Furthermore, depending on the degree of labor flexibility cross-border provision of services and portability of acquired rights are important reform considerations, which will need to be addressed in the framework of harmonization of key regulations and coordinated supervision across countries.

**E. Recommendations of the Evaluation Office regarding sector loans in Nicaragua**

- 1.28 The Bank's Office of Oversight and Evaluation (OVE) report on the execution of the Trade and Finance Adjustment Program<sup>8</sup> draws lessons from that loan which are relevant generally for future sector loans in Nicaragua. The report concludes that the Program failed to achieve its objectives in large part due to the lack of commitment and credibility of the Nicaraguan authorities regarding some of the envisaged reforms, specifically with regard to the sensitive issue of state banking sector reform. Furthermore, the report notes as additional reasons the lack of precision of the disbursement conditions and the Bank's willingness to disburse the loan resources without requiring full compliance with the conditions.
- 1.29 The proposed operation reflects the lessons outlined in the OVE report. GON has advanced substantially in the design and implementation of the reform program, especially in the area of sensitive legal reforms and adjustments to the current system, demonstrating a strong commitment with the program objectives. Furthermore, the operation has identified and been structured around a reduced number of clearly defined design and implementation benchmarks, compliance of which can be measured in a transparent way.

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<sup>8</sup> PPR-14/97, October 1997. The *Programa de Ajuste Comercial y Financiero* (864/SF-NI, 638/OC-NI) was approved in October 1991 for US\$130 million and final disbursement occurred September 1992.

## II. THE PENSION SYSTEM – CURRENT SCHEME AND REFORM APPROACH

### A. The present pension system

- 2.1 *Nicaragua's mandatory public pension system suffers from low and unequal coverage, as well as a structural imbalance between its contribution and benefit profile, leading to growing financial imbalances. Without fundamental reforms, the pension system is unsustainable.*
- 2.2 Nicaragua's current public social security system was created in 1957<sup>9</sup>, covering initially only public sector employees employed in the capital. Sector and regional coverage was extended gradually over the following decade and universal coverage was formally achieved by 1967. The system covers employees' Old Age, Disability and Survivor insurance, as well as health care benefits and workers compensation insurance<sup>10</sup>. The system is funded through compulsory payroll contributions for all private and public sector employees and voluntary contributions for self-employed. Presently it provides the only source of universal public social security coverage in the country, with the exception of an independent system administered by and for the military.<sup>11</sup> Since its creation the system has been administered by a public entity, the Nicaraguan Institute of Social Security (INSS)<sup>12</sup>.
- 2.3 The Old Age, Disability and Survivor insurance (IVM)<sup>13</sup> component of the system is designed as a Defined Benefit, pay-as-you-go (PAYG) scheme, whereby current contributors finance current pension payments to earlier generation contributors. As is generally the case in PAYG schemes, eligible retired affiliates receive benefits that are unrelated to their contributions over their working life, but linked to their most recent salary history.
- 2.4 The table below provides an overview of conditions and benefits of the present, pre-reform pension system.

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<sup>9</sup> A precursor to the pension component was already established in 1930 for retired teachers. Over the next decade insular, sector specific coverage was established for rail-workers, the public banking sector and the armed forces.

<sup>10</sup> Seguro de Enfermedad y Maternidad (E&M), Riesgos Profesionales (RP)

<sup>11</sup> Since the early 1990's private health insurance is again available in Nicaragua, however coverage is not wide spread. Equally, company retirement arrangements are not generally available.

<sup>12</sup> Instituto Nicaragüense de Seguridad Social

<sup>13</sup> Invalidez, Vejez y Muerte

**Table II-1**

**Characteristics of the Pension System—Current Situation and Reform Scenario**

	<b>Defined Benefit System</b>	<b>Defined Contribution</b>
Retirement Age (years)	60	n.a. (62 min. pens.)
Vesting Period (years)	15	n.a. (25 min. pens.)
Contribution Rate <sup>14</sup> (%)	5.5 <sup>2)</sup>	10.5%
Averaging Period Reference Salary (years)	3 – 5	n.a.
Minimum Replacement Rate (%)	56.4 <sup>1)</sup>	n.a.
Maximum Replacement Rate (%)	80 <sup>1)</sup>	n.a.
Average Initial Replacement Rate (%)	69.4 <sup>1)</sup>	63 <sup>15</sup>
Maximum Contributing Salary (US\$)	2,671	1,500
Maximum Pension Benefit (US\$)	1,500	n.a.
Minimum Pension	Min. wage	Yes

<sup>1)</sup> First year of pension. Pensions are not indexed and real replacement rates drop in line with inflation.

<sup>2)</sup> Prior to parametric reform; currently 10%.

Source: INSS, various

**2.5 Coverage – ratio and characteristics.** Coverage of the system has varied substantially since its inception. Until the late 1970's coverage increased only gradually, due to the very slow phasing in of services beyond Managua and the public sector. The number of contributors expanded in the first half of the 1980's, albeit remaining low in international comparison, triggered by the easing of eligibility and the inclusion of independent and rural workers, as well as the expansion of the public enterprise sector. The ratio of contributors to economic active population (EAP) increased from 16.8% in 1980 to a peak of 27.5% in 1984. This trend was reversed during the economic crisis of the following years, when growing unemployment, increased labor informality and a substantial reduction in real wages led to a marked decline in the ratio beginning in 1988, which dropped to 13% by 1995.

**2.6** Over the last five years the number of contributors has risen to approximately 250,000 by the end of 1999, representing 17% of EAP. Urban medium and high-

<sup>14</sup> Additional contributions to the social security system as percentage of the computable salary include 8.5% E&M, 1.5% RP and 1.5% war veterans payments. Those remain unchanged.

<sup>15</sup> This assumes 25 years of contribution at a 7% rate and a ROI of 7% p.a. in real terms, calculated over the average salary of the last 10 years prior to retirement.

- income earners and public sector employees constitute the majority of contributors. Almost 49% of all contributors belong to the highest income quintile. Urban contributors outnumber rural at a ratio of 4:1; more than half are employed in large companies (50+ employees), the sub-sector with the highest contribution ratio at more than 3/5 of all employees. Clearly, the current system mainly serves a small fraction of comparatively well off employees, representing in effect an income transfer toward that economic segment, given its fiscal implications.
- 2.7 The expansion of coverage during the 1980's was accompanied by a broadening of the benefits provided by the system. The number of years of contribution required for pension eligibility was reduced and disability pensions grew substantially. In addition, extensive special pension programs, such as the war veterans program and other non-contributive pensions were established.<sup>16</sup> By 1985 special and non-contributive pensions, including survivor benefits, outpaced regular IVM pensioners and until mid 1990's war veterans doubled old age pensioners. In 1997 43,130 (45.1%) out of the almost 100,000 pensions paid by the INSS corresponded to non-contributive pensions.
- 2.8 ***Financial characteristics – structural imbalances and evasion a source of deficits.*** The contribution and benefit structure of the current IVM system and its administrative weaknesses have led to the emergence of financial imbalances, including a cash deficit since 1993. Although those imbalances are still fairly small in comparison to those observed in other countries' public retirement systems, absent any reform to the system, they will grow significantly in the future, as the old age dependency ratio increases in the coming decades. The cash flow deficit at the end of 1999 was estimated at 0.8% of GDP and actuarial calculation project it at 2.1% by 2010 and 4.9% by 2020. Moreover, those calculations preliminarily estimated that pension funding could be wholly dependent on fiscal transfers by early in the next decade, once remaining INSS funding reserves of approximately US\$40 million were depleted. The Implicit Pension Debt (IPD)<sup>17</sup> of the unreformed system could rise from 85% of GDP in 1996 to over 400% of GDP by the year 2030, without changes in contribution rates and benefits, and improvements in system administration.
- 2.9 High evasion rates and the substantial administrative costs of the system compound the system's financial imbalances. Whereas INSS inefficiency results in estimated administrative costs equal to 15% of pension benefits<sup>18</sup>, evasion rates are estimated at 55% of the system's potential contribution from current affiliates, due to substantial underreporting and payment default. The latter is estimated in excess of 10% of contributions and aided by inadequate information systems for collection and inspection and a lack of enforcement.

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<sup>16</sup> The war veterans program is financed by a 1.5% salary contribution of all contributors.

<sup>17</sup> Present Value of contracted future retirement obligations.

<sup>18</sup> That compares to 2.5% to 5% for most Latin American countries and 1.5% to 2% for Organization for Economic Corporation and Development (OECD) countries.

- 2.10 The system's characteristics provide strong incentives for improper income reporting and evasion and a rational for a “taxation perception” by the contributors. Despite the disassociation between contributions and benefits, benefits are in effect very low. The average real replacement rate of old age pension is estimated around 40%, reflecting the lack of inflation indexation of benefits and the substantial erosion of values during the late 1980’s and early 1990’s. The short vesting period and averaging period for the reference salary induce under-reporting of income during most of employees’ working life and over-reporting during the final five years of contribution.
- 2.11 To maintain the PAYG system under its present benefit formula the contribution rate would have to rise substantially: from 5.5% in 1999 to an estimated 17.3% by 2030 and 36.4% by 2060. Alternatively, maintaining the current contribution rate would require, *ceteris paribus*, reducing the ongoing replacement rate to below 15% over the same period. While the latter option would lead effectively to the demise of the PAYG system, the former would not eliminate the potential for future government pension liabilities, since the system would remain open and imbalances could continue to build up, depending on the development of the actuarial components.
- 2.12 Given the fiscal implications of the system’s structural imbalances and the fact that the deficits will increase substantially over time, the system’s low and unequal coverage rate and its low old age dependency ratio, a structural reform of the pension system constitutes a viable option. Present costs of a reform, as measured by the IPD, are comparatively low, and eliminating or limiting the fiscal implications of the system would reduce a regressive redistribution of income.

## **B. Pension reform approach**

- 2.13 *The central element of the GON pension reform is the full privatization of pension provision through the introduction of a mandatory, fully funded Defined Contribution system (DC) administered by private fund managers. To reduce the fiscal costs of the old system and the transition period, the reform also includes adjustments to the PAYG contribution and benefit structure.*
- 2.14 The system's deficiencies, its short-term financial imbalances and its doubtful long-term viability prompted the Nicaraguan government in 1998 to initiate a fundamental reform program. The reform aims at limiting the large fiscal imbalances of the present system and at establishing a contributor self-financed alternative. The reform comprises two elements: (i) the establishment of an independent new system, and (ii) parametric adjustment to the PAYG system.
- 2.15 The central element of the reform approach is the creation of a mandatory, fully funded, defined-contribution (DC) scheme. The DC system will be based on individual capitalization accounts managed by private pension fund administrators (PFA). The PAYG system will be closed to new entrants of all ages and with only current affiliates age 43 and older, as well as retirees and pension beneficiaries

still to remain in the system. Affiliates age 43 or younger will be obliged to migrate to the DC scheme.<sup>19</sup> Based on affiliation data through the end of 2000 it is estimated that approximately 220,000 active contributors will migrate to the new system. Accrued retirement claims of those migrating to the new system will be recognized through Recognition Bonds.

- 2.16 The closure of the PAYG system and the privatization of pension provision and insurance responsibility for new entrants and younger contributors effectively limit the fiscal costs of dismantling Nicaragua's public pension system to its current size. Moreover, the parametric adjustments to the PAYG system contribute to a further reduction of the fiscal effects of the reform. In projections ranging until 2060, the Implicit Pension Debt of the reformed system is estimated between 57% and 80% of GDP, substantially less than the estimates for all other scenarios. Nevertheless, the transition will require fiscal resources to offset negative cash flows, specifically during the first years of transition, due to the loss of revenue from contributors age 43 and younger. Cash flow-needs will peak around 2020<sup>20</sup>, with a deficit of approximately 2.6% of GDP, then declining rapidly and petering-out at mid century. However, these projections do not include the potential fiscal obligations derived from the state-guaranteed minimum pension.
- 2.17 The parametric adjustments aim to increase contributions from current affiliates while gradually adjusting benefits eligibility. Parametric reforms were enacted in 2000 and include the immediate increase of the contribution rate from 5.5% to 10% and adjustments in the wage base applied for benefits calculation. Although the adjustments extend the financial life span of the PAYG system and reduce the fiscal costs, the system is estimated to still encounter a cash flow deficit by 2040, deplete its reserves by 2048 and generate an IPD of above 250% of GDP beginning in 2030.
- 2.18 Parallel to the reform of the PAYG system, a strengthening and modernization program for INSS was initiated with the aim to establish the institute as a manageable on-going economic concern. For the design and implementation of the program the accounting and advisory company KPMG was contracted as the principal Modernization Partner. Central elements of the program are (a) the financial separation of IVM and other social security services offered by INSS; (b) the auditing of all accounts and adjustments to the financial statements, as well as introduction of accepted accounting standards; (c) the modernization of planning, process and reporting systems; and (d) introduction of automated management and information tools. Furthermore, in the area of IVM the modernization program undertook a comprehensive review of all active and

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<sup>19</sup> During initial discussions of reform models in the mid 1990's a cut-off age of 45 years was established, which coincided with a phasing in period of 15 years for proposed adjustments and a retirement age of 60 years. Furthermore, at this point more than 80% of all contributors would have been covered by the proposed adjustments. In subsequent reform design iterations the initial cut-off age was maintained.

<sup>20</sup> At that point no contributions will be received in the PAYG system and the first contributors age 43 and younger will enter retirement, requiring the payment of Recognition Bonds to cover contributions to INSS.

dormant retirement accounts, establishing for all affiliates their contribution, employment and salary histories in order to determine eligibility for pension benefits and Recognition Bonds. INSS has also increased its enforcement and collection efforts.

### **C. Reform implementation – principal aspects**

- 2.19 Substantial progress has been achieved in the approval of the legal and regulatory framework for the new pension system and the adjustments to the PAYG scheme. Nevertheless various technical issues still need to be addressed and the actual implementation of the new system has yet to commence.
- 2.20 **Legal Framework.** During 2000, the Government has progressed substantially in the implementation of the reform measures<sup>21</sup>, especially in establishing the legal and regulatory framework for the DC system and enacting the parametric reforms of the PAYG system. The latter were introduced by decree in April 2000 (Decreto 32-2000). In March 2000 Parliament approved the new Pension Law (Ley No 340, *Ley del Sistema de Ahorro para Pensiones*), which establishes the institutional structure of the DC system, followed by the decree of implementing legislation in June. The latter comprise, inter alia, the law's General Regulations (*Reglamento General* Decreto Ley 55-2000), as well as regulations regarding the Recognition Bonds (Decreto Ley 57-2000) and the investment regime of the pension funds (Decreto Ley 56-2000).
- 2.21 In March 2001 Parliament approved the Pension Superintendence Law (Ley No. 388, *Ley Orgánica de la Superintendencia de Pensiones*). The legislation establishes the mandate and authority of the institution as an administrative and politically autonomous entity. Moreover, the law establishes in very much detail the organizational structure of the Superintendence and functions of its main units. Although the legislation establishes a satisfactory broad framework for the Superintendence, issues to be considered for further analysis are the governance structure of the institution, its capacity for enforcement and the sanctions regime, and its financing and budgetary rules, as well as attributes and competence with regard to market/competition regulations. To complement Law 388 implementing regulations are currently drafted.
- 2.22 The legal and regulatory framework of the Defined Contribution system incorporates lessons learned and best practices regarding pension reform. In particular, the design takes into account the limited size and narrowness of financial markets in Nicaragua and the constraints this could place on the development of a competitive pension industry. Main aspects of the pension legislation and the institutional configuration of the system are as follows.

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<sup>21</sup> Reform design and implementation is under the direction of an inter-ministerial commission comprising the Ministry of Finance, the Central Bank, INSS and the Technical Secretariat of the Presidency (SETEC), who coordinates its activities. The commission reports directly to the Presidency of the Republic.



- 2.23 ***Institutional Characteristics.*** The institutional structure of the DC system revolves around the creation of individual capitalization accounts for all contributors<sup>22</sup>, which will be administered by specialized private Pension Fund Administrators (PFA). PFA have to be incorporated in Nicaragua and their operations must be licensed by the Pension Superintendence. Required initial capital is US\$2 million, which is to be increased according to the number of affiliates up to a maximum of US\$2.5 million. Operating licenses are to be granted based on a review by the Pension Superintendence of the proposed business plan of the prospective investors.
- 2.24 The pension legislation authorizes the PFA to substantially provide all services related to the administration of the individual capitalization accounts and pension benefits. The notable exception is the collection of contribution, which will remain centralized with INSS. Given current information, systems and branch network advantages of INSS the centralized approach is considered to allow for cost advantages. Nevertheless, the law allows for the outsourcing of those services to the private sector in the future, if deemed more adequate solution.
- 2.25 The legislation takes account of the reduced size of Nicaragua's markets and the inherent potential for substantial insider and related party operations in detriment of the pension funds. It establishes clear distinctions between the PFA resources and the pension resources and prohibits any use or responsibilities of the latter for purposes of the former. Furthermore, it establishes restrictions in the Governance structure of the PFA and on related party investments.
- 2.26 While financial institutions can invest in PFA their directors, administrators and staffs are bared from assuming management and board functions in the institution. The legislation provides for Fit & Proper Rules for PFA investors and directors and establishes the mandatory appointment of outside directors to the PFA Board. Moreover, financial disclosure rules, as well as confidentially and insider trading dispositions for PFA directors and administrators are established by the legislation. Furthermore, related party investments by PFA are prohibited, with the limited exception of banks' or finance companies' liabilities. Although the precise limits for the latter are to be established by the Investment Committee, they will be constrained by a maximum exposure for accumulated investments of 10% of PFA pension assets or 5% of the financial institution's assets. The pension fund legislation defines "related parties" as those with a direct or indirect interest of 3% or more in the equity of the PFA or those which present a direct or indirect economic participation of PFA, their shareholders or administrators of 10% or more.

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<sup>22</sup> The new system will cover all public and private sector employees, with the exception of members of the armed forces, as well as self-employed workers. The latter are eligible to contribute voluntarily to the system, based on any declared salary exceeding the legal minimum wage, whereas contributions are mandatory for salaried employees.

- 2.27 **Supervision.** The pension system, i.e. PFA, INSS and other service providers, will be supervised by the newly created Pension Superintendence. Although arguably some economies of scope and scale could be achieved by centralizing all financial sector supervision in one body, concerns regarding specialization of functions, conflicts of interest, a broader mandate and public perception of autonomy favored the decision for a stand-alone institution.<sup>23</sup> Nevertheless, institutional arrangements will be put in place to ensure an adequate exchange of information and know-how between the Banking Superintendence and the Pension Superintendence, especially in the area of responsibility of the former for insurance and capital market supervision. The Pension Superintendence's governance structure will facilitate the coordination between both supervisory organs, given that the Banking Superintendent is a permanent member of the Pension Superintendence's board.
- 2.28 **Contribution Structure.** Mandatory contributions to the DC system have been established at 10.5% of the computable salary base, with a maximum income base of US\$1,500; 6.5% are to be financed by the employer and 4% by the employee.<sup>24</sup> Contribution rates for voluntarily affiliated self-employed are 10.5% of the declared computable salary up to US\$1,500. Contributions are tax-exempt. Commissions for the administration of the individual capitalization accounts are capped at a maximum of 3% of the salary base, during the first 36 months of system operation, and thereafter at 2.5%. The commission includes the costs of the mandatory disability and survivor benefit insurance to be provided by the PFA through subcontracting.<sup>25</sup>
- 2.29 **Investment Regime.** The investment framework for the system reflects the lessons learned of earlier reforms and the comparative shallowness of Nicaragua's financial system. The framework allows for investments in private and public domestic debt and equity instruments, as well as commercial banks' term deposits and mortgage-backed securities. In addition, international investments will be allowed from the outset at a rate of up to 30% of pension funds. Although an even higher portion of international investments could have been contemplated, given the degree of development of the country's financial markets, the established maximum is considerably higher than currently in all other Latin American reform countries. The inclusion of international investments reflects GON commitment to enhance the risk/return profile of pension assets. Facilitating international investments should not have repercussions in the foreign exchange or foreign reserve positions, given the high degree of dollarization of financial assets and the anticipated volume of funds.

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<sup>23</sup> Nicaragua follows with this approach the example of almost all other reform countries in Latin America which have separated pension and banking supervision, although in some cases pension supervision forms part of a broader mandate for the corresponding entity to supervise the capital markets.

<sup>24</sup> Total social security contributions, including health and maternity benefits, are 21.5% of the salary base.

<sup>25</sup> It is estimated that the premium costs will equal 1.2-percentage points of the contribution, given experience in other countries. However, costs will depend on the claim rate.

- 2.30 A special “Risk Commission” chaired by the Pension Superintendent will define specific limits of risk exposure to any given instrument or issuer and determine maximum term structure of debt instruments, within the ranges established by the pension law. Investments in Non-Government debt will need to be qualified by two independent classification agencies approved by the Superintendence.
- 2.31 The following table provides an overview of selected investment limits by instruments, issuer and risk exposure of the pension fund.

**Table II-2**

<b>Instruments/Issuer</b>	<b>Limit range</b>
Debt issued or guaranteed by GON/BCN	30% - 50%
CD, Bonds or other titles issued or guaranteed by financial institutions	30% - 50%
Debt issues of public and private enterprises	30% - 50%
Convertible debt of public and private enterprises	10% - 20%
Stock of public and private enterprises	5% - 10%
Mortgage-backed securities	20% - 30%
International equity or debt issues	10% - 30%
Other publicly trade, registered instruments, issued by regulated institutions	As determines Superintendence
Issuer Limit	5% of fund assets 10% of issuer assets
Issue limit	20% of volume

Source: Law 340, Decree 56-2000

- 2.32 ***Pension Eligibility and Minimum Pension Benefits.*** Affiliates are entitled to receive pension benefits beginning at the age of 60 or once the value of the accumulated contributions, i.e. the fund value, is sufficient to finance a pension with a replacement value of at least 60% of the contributive salary, allowing for a benefit of 160% of the minimum pension. However, the state guarantees minimum old age, disability and survivor benefits, in those cases in which accumulated contributions are insufficient to cover the minimum pension. The design of the benefit seeks to avoid the creation of large unfunded future liabilities, discouraging “strategic evasion”, and a significant leakage of old age income transfers to the non-poor. Only contributors 62 years and older with 25 years of contribution are eligible for old age benefits. Disability and survivor benefits require ten years of accumulated contribution and active contribution status at the time of occurrence. Minimum old age and survivor benefits are related, but below, the official minimum wage<sup>26</sup>, and legislation provides Government with discretionary authorities for adjustments according to wage or inflation development; survivor benefits cover a part of the old age pension. Fiscal costs of the minimum pension have not yet been quantified, given the uncertainty surrounding affiliation ratios and investment returns of the pension funds.
- 2.33 ***Recognition of Contributions to PAYG.*** Current INSS affiliates age 43 or younger, with a contribution history of at least 12 months, will receive a Recognition Bond, recognizing accrued pension rights. Bonds will be redeemed at old age or disability retirement or the death of the account holder. The valuation of the Bonds takes into account the actual contribution history of the affiliate, adjusting expected benefits by the corresponding actuary factors. The maximum replacement rate of the Bonds will be 69% of the average salary over a four-year period.<sup>27</sup> Bonds will be inflation indexed but not interest bearing. The costs for the bonds is estimated to peak in 2019 at 1.98% of GDP and discounted present value is circa US\$400 million.
- 2.34 ***Financing of Fiscal Costs.*** At present GON has not defined a detailed strategy how to cover the expected long-term fiscal costs associated with the system transition. Based on actuary assessments during the reform design, the net present value of the latter are estimated to exceed US\$1,300 million or 85% of projected GDP, without including the eventual costs of the guaranteed minimum pension.<sup>28</sup> Those costs which comprise current retirement payments, future retirement payments for beneficiaries remaining in the INSS and the payment of Recognition Bonds for contributors who are transferring to the new system, mainly recognize

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<sup>26</sup> Currently the official minimum wage is C\$600/month, equal to US\$45. An increase to C\$900/months, US\$68, is expected.

<sup>27</sup> The calculation for the Recognition Bond is:  $RB = 0.693671 * p^{*12} * t/k * a$ ; where  $p^{*12}$  denotes the average annual salary over the last 48 months;  $t/k$  the relative individual contribution history (t) to average system wide number of years of contribution (k), and (a) is the actuary adjustment factor.

<sup>28</sup> The estimate assumes a discount rate of 4%. At 6% the costs would be slightly below US\$1,000, equivalent to 57% of expected GDP.

the currently accrued pension liabilities of the state<sup>29</sup>. A number of potential revenue sources have been preliminary identified, in addition to domestic debt and external financing. Those include: (a) improved return on investment of INSS current reserves, which are estimated at US\$40 million, not including substantial overdue payments. Those reserves are invested mostly in public debt and fixed deposits in the national banking system; (b) continued application of the 1.5% surcharge for non-contributive and war victims' pensions on all salaries subject to social security deductions. Given the anticipated actuary profile of the beneficiary population the surcharge will allow for an increasing positive cash-flow contribution to the PAYG system; (c) cross-subsidies from other branches of the social security system; and (d) the transitory application of DC contributions toward PAYG funding.<sup>30</sup> This latter option would reduce investment resources and the expected retirement benefits of the transition generation, but would allocate the burden principally with the beneficiaries, reducing regressive effects.

- 2.35 ***Competition and System's Costs.*** Competition concerns and system's costs are important aspects of the institutional design of the reform, given the reduced size of the market, i.e. the comparatively low number of affiliates<sup>31</sup> and limited volume of contributions<sup>32</sup>. Although the import of pension administration services is not permitted, the legislation allows for the un-bundling and outsourcing of ancillary services, such as contribution processing, data management, pensions payments etc. This could induce the development or import of specialized services, increasing overall competition in the market. Nevertheless, collection of contribution is expected to remain centralized, given the cost advantage of established infrastructure.
- 2.36 System design also limits contributors' right to transfer between different PFA to once during every twelve months contribution period and grants the Pension Superintendence some latitude to intervene in excessive or misleading commercial spending, in an effort to further reduce costs pressures in the system. This reflects the experience in other Latin American reform countries, where substantial commission rates resulted from elevated commercial costs, aimed mainly at inducing frequent changes of PFA by contributors.
- 2.37 Freedom, albeit limited, in the pricing and structure of products could further enhance competition in the industry. While commissions are capped at 2.5 percentage points of the salary base, there is no impediment to compete on prices below the cap. The ample variety of potential investments, coupled with the fact

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<sup>29</sup> Only the provision of a state guaranteed minimum pension adds a new fiscal obligation to the reform.

<sup>30</sup> The Pension Law allows for the application of up to 1 percentage point of the contributions during a transition period of 15 years.

<sup>31</sup> Experience of other reform countries with an increase in the affiliation ratio has been mixed. Whereas El Salvador registered a significant increase from a very low base, Mexico only experienced a modest increase. Even taking the El Salvador case as a baseline the number of affiliates in Nicaragua would likely not surpass 350,000 in the foreseeable future, about half the number of affiliates in El Salvador.

<sup>32</sup> Annual contributions to the system are estimated to increase from US\$43 million to approximately US\$86 million within a five-year timeframe.

that the legislation does not establish mandatory performance benchmarks should also facilitate increased competition. Moreover, the Pension Law explicitly contemplates the possibility for price discrimination based in affiliation periods. In addition, after a five-year start-up period with a single product offering PFA will be allowed to establish additional investment funds, differentiating the product by its investment policy and commission level.

- 2.38 ***Implementation Schedule.*** Even though the design and implementation of the new system has advanced substantially during 2000, the drafting, presentation and approval of the statutory law of the Pension Superintendence suffered some delay, extending the implementation period. Following the recent approval of this law it is expected that the Superintendence will initiate implementation activities by the third quarter. PFA will be licensed before the end of 2001. Affiliation of contributors could commence by the first quarter of 2002.

#### **D. IDB and World Bank support**

- 2.39 The preparation and implementation of the reform is supported by a technical cooperation grant from the MIF<sup>33</sup>, which finances: (i) the establishment of an adequate legal and regulatory framework, and (ii) the implementation of the Pension Superintendence. In addition, the World Bank approved a technical assistance loan to finance: (i) the design and implementation of a public awareness campaign; (ii) measures to strengthen the financial system and promote the development of the insurance sector; and (iii) technical assistance to support the implementation of the reform. This operation has initiated disbursements recently. The IMF supports the pension system reform. Implementation of reform measures is part of the structural performance criteria of the Poverty and Growth Facility and it is included in the policy agenda to be implemented by GON in the framework of the HIPC initiative.

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<sup>33</sup> ATN/MT-6573-NI, Support to the legal framework of the new pension system and creation of the Pension Superintendence in Nicaragua, approved July 1999.

### III. THE SECTOR PROGRAM – OBJECTIVES AND DESCRIPTION

#### A. Objectives and structure

- 3.1 The objective of the proposed operation is to support the Nicaraguan Government's reform of the country's mandatory PAYG pension system, which is aimed at containing the fiscal costs of the present scheme and the establishment of a financially sustainable DC system. The later is expected to provide increased coverage and benefits for Nicaragua's working population. The proposed operation would provide resources that will contribute toward maintaining macro economic stability during the initiation of the reform process and would allow GON to finance a portion of the transition costs of the reform

#### B. Program description

- 3.2 The program entails a set of measures and action to be taken, which comprise fundamental elements of the reform policy of Government for the pension sector. Disbursements of program resources would be conditioned on satisfactory compliance with stipulated reform and policy actions, as well as the maintenance of a satisfactory macroeconomic framework, within the context of implementation of an IMF program. Contemplated measures and actions cover policy priorities for the design and implementation of the reform in five principal areas: (i) establishment of the legal framework for the new system, (ii) implement the parametric reform of the current defined benefit PAYG system, (iii) establishment of the institutional arrangements for supervision and service provision, (iv) establishment of a financing plan for transition costs, and (v) initiation of implementation. The conditions for disbursements are summarized in the Policy Matrix in Annex I and described in the following sections. Furthermore, the *Policy Letter* provided in Annex II describes the authority's commitment with regard to the macroeconomic and sector policies, which will form the framework for the execution of the program.
- 3.3 The operation has been structured with two disbursements, the first for up to US\$20 million and the second for up to US\$10 million. The "front-loading" of the disbursements recognizes the substantial advances realized by GON in the design and implementation of the reform process. *First disbursement would become effective upon approval of the operation by the Bank's Board, pursuant to compliance with all established conditions.* A number of first disbursement conditions will have been complied with prior to Board presentation of the proposed operation, and will be included in the loan contract as "conditions complied with prior to approval of financing". First disbursement conditions which have not been concluded or which documentation is still pending, will be include in the loan contract as "conditions prior to first disbursement".

## **C. First disbursement conditions**

### **1. Macroeconomic framework**

- 3.4 Since 1998, GON has been implementing an IMF-supported three-year economic program under the Poverty Reduction and Growth Facility (PRGF), with the aim to reduce fiscal deficits, increase the balance of payment position and advance structural reforms. Program performance in 1999 and 2000 permitted Nicaragua to reach the HIPC decision point at the end of 2000. Currently, GON and Fund authorities are negotiating the third year program under the PRGF. Important elements of the program are the need to reduce fiscal imbalances and reverse the substantial loss of NIR. Structural performance benchmarks of the program will include measures in the financial system, the reform of the pension system and progress in the privatization of the public utilities. *Government will maintain a macroeconomic framework consistent with program objectives as a condition prior to first disbursement.*

### **2. Legal Framework**

- 3.5 On March 15<sup>th</sup>, 2000 Parliament approved the pension system law, *Ley del Sistema de Ahorro para Pensiones*, Law 340, that creates the legal foundation for the establishment of the fully funded defined contribution system. Inter alia, Law 340 establishes: (i) the system's general characteristics, e.g. system's components, mandatory and voluntary affiliation, and contribution regimen; (ii) the rules governing Pension Fund Administrators, e.g. their establishment, ownership and governance structure, as well as administration, pension funds definition and management and investment regime; (iii) the characteristics of pension benefits, e.g. definition of beneficiaries, financing and characteristics of pensions and the state minimum pension guarantee; and (iv) the system's supervision and regulation through the Superintendence of Pension. Law 340 was published April 11<sup>th</sup> and 12<sup>th</sup>, 2000 in the official newspaper *La Gaceta*. *Publication of Law 340 complies with a condition prior to first disbursement.*
- 3.6 On March 22, 2001 Parliament approved the Pension Superintendence law, *Ley Orgánica de la Superintendencia de Pensiones*, Law 388, that establishes the institution and defines, inter alia, (i) the governance structure; (ii) attributes of its organs and officers; (iii) organizational structure; and (iv) financing. Law 388 was published April, 2001 in the official newspaper *La Gaceta*. *Publication of Law 388 complies with a condition prior to first disbursement.*
- 3.7 Following the approval of Law 340, the Executive approved implementation regulations during June 2000. Specifically, the following main regulations were approved: (i) General Implementation Regulations, *Reglamento General de la Ley del Sistema de Ahorro para Pensiones*, Decreto No. 55-2000; (ii), Investment Regulations, *Reglamento de Inversiones para el Sistema de Ahorro de Pensiones*, Decreto 56-2000; and (iii) Recognition Bonds Regulations, *Reglamento de Certificado de Traspaso*, Decreto 57-2000. The implementing regulations were



published June 27<sup>th</sup> and 29<sup>th</sup>, 2000 in the official newspaper *La Gaceta*. *Approval of Decreto No. 55-2000, 56-2000 and 57-2000 by the Executive and publication in La Gaceta complies with conditions prior to first disbursement.*

- 3.8 The pension legislation establishes that pension fund administrators can invest a maximum of up to 30% of pension funds in international investment instruments. The characteristics of eligible international investments will be established by a specific implementation regulation. The regulations will maximize the international investment limits to facilitate an improved risk diversification of the investments and reduce strains on the domestic capital markets. Furthermore, the regulation will establish appropriate investment limits to allow diversification and minimize currency risks. *Approval by the Executive and publication in the official newspaper La Gaceta of a satisfactory international investment regulation (Reglamento de Inversiones en el Extranjero) will be a condition prior to first disbursement.*

### **3. Parametric Reforms**

- 3.9 The introduction of the new fully funded defined contribution system is accompanied by adjustments to the defined benefit PAYG, aimed at reducing the fiscal costs during the transition period and aligning the parameters of the two competing systems. Specifically, per Executive decree, Decreto 32-2000, the contribution rate was adjusted in one single step in 2000. *Approval of Decreto No. 32-2000 by the Executive and publication in La Gaceta complies with conditions prior to first disbursement.*

## **D. Second disbursement conditions**

### **1. Macroeconomic framework**

- 3.10 The Government of Nicaragua will pursue a macroeconomic policy consistent with the program's objectives. *Government will maintain a macroeconomic framework consistent with program objectives as a condition prior to second disbursement.*

### **2. Legal framework**

- 3.11 Law 388, *Ley Orgánica de la Superintendencia de Pensiones*, requires the Executive to pass implementing regulations to define: (i) the procedures to select and replace Board members; (ii) the Board's functioning; (iii) the definition of violations and sanctions regime; and (iv) the definition of conflict of interest rules for INSS participation in Superintendence Board. *Approval by Executive and publication in the official newspaper La Gaceta of satisfactory general implementation regulation (Reglamento General) for Law 388 will be a condition prior to second disbursement.*

### **3. Institutional framework**

- 3.12 Law 388, *Ley Orgánica de la Superintendencia de Pensiones*, establishes the Pension Superintendence as regulatory and supervisory organ of the system. In the framework of the proposed operation GON will establish the institutional basis for the operation of the Superintendence, through the following specific actions: (i) appointment of the Superintendent; (ii) appointment of Superintendence board; (iii) establishment of Superintendence budget and allocation of resources for first year of operation; (iv) contracting of adequate staff complement to initiate operations; (v) development and approval by Superintendence Board of relevant operative and administrative procedures and manuals; (vi) design of reporting and information system, and (vii) development and approval by Superintendence Board of ethic rules for Superintendence staff. Government will provide documentary evidence for action (i) through (iii) and documentation of Pension Superintendence Board approval is required for action (iv) through (vi). *The Pension Superintendence's operability will be a condition prior to second disbursement.*
- 3.13 To prepare for the implementation and operation of the new system, especially with regard to the licensing of Pension Fund Administrators (PFA), their operations and the affiliation of contributors, the Pension Superintendence will issue a number of norms and regulations. Specifically, the Pension Superintendence will issue satisfactory norms pertaining to: (i) the criteria for eligibility and licensing of PFA; (ii) the rules and timeline for affiliation of current INSS contributors under 43 years of age; (iii) affiliation rules for new mandatory contributors and voluntary self-employed contributors; (iv) risk classification and ratings rules for pension fund investments; (v) related party investment norms; (vi) rules and pricing for collection and transfer of contributions; and (vii) chart of account and accounting rules. *Pension Superintendence Board approval of the norms, their publication and their effectiveness will be will be condition prior to second disbursement.*

### **4. Financing plan**

- 3.14 The pension system reform will reduce substantially the fiscal impact of pension provision over the medium term, once the transition from the defined benefit PAYG system to the fully funded defined contribution system is completed. During the transition period fiscal resources will need to cover the costs for current and future pensioners under the PAYG system, given the reduction in cash-flow, as well as the costs of accrued pension rights of INSS contributors moving into the new system. Total costs as a percentage of GDP are estimated to peak at 2.6% around 2020 and than decrease rapidly over the following decades until reaching zero towards the end of the century. Financing of those costs should be done in a manner to avoid or minimize regressive income distribution effects for the population as a whole. In addition to the fiscal costs of accrued pension rights, Law 340 establishes a guaranteed minimum pension for all affiliates with a minimum contribution history of 25 years, which costs will need to be covered by

Government. Government will present an actuary assessment of the fiscal costs of the reform, including the costs of the guaranteed minimum pension for contributors to the new DC system. Based on the cost estimate a satisfactory financing plan will be developed and approved by the Inter-Ministerial Committee for the Reform of the Pension System. *Preparation of an assessment of the long-term fiscal costs of the reform, including the cost of the minimum pension under the new system and establishment and approval by the Inter-Ministerial Committee for the Reform of the Pension System of a satisfactory financing plan, will be condition prior to second disbursement.*

## **5. Implementation of system**

- 3.15 INSS contributors 43 years or younger are mandated to migrate to the new system, having their accumulated contributions recognized through a deferred Recognition Bond. The Bond's value will be established as a function of contribution and salary history, adjusted for actuary factors and will be placed in custody of the PFA selected by the affiliate. To facilitate this process all affiliates' contribution histories will have to be established by INSS and rules will need to be in place and approved by the Pension Superintendence for the calculation of Bonds' values at the time of affiliation at a PFA and their transfer into PFA custody. INSS will provide a representative sample review of affiliates' contribution history by its external auditor. The Pension Superintendent will certify the calculation of Recognition Bond values for all eligible INSS contributors and will establish rules for the effective calculation of bonds' value and their transfer in custody of PFA. *Determination of the contribution histories of all INSS affiliates to be transferred to PFA and approval of rules governing the calculation of Recognition Bonds' value and their transfer into custody of PFA will be condition prior to second disbursement.*
- 3.16 Establishing the legal and regulatory framework provides the necessary groundwork for the full implementation of the system, i.e. the licensing of PFA and the affiliation of contributors. Completion of the evaluation and selection process for PFA and resolution by Superintendence granting operating licenses to PFA will be required, as well as ratification by Pension Superintendence of a time-bound plan for their initiation of activities, as well as a time-bound plan for the transfer of eligible INSS contributors to the new system. Completion of the evaluation and selection process for PFA and *licensing of operations of at least two Pension Fund Administrators by the Pension Superintendence will be condition prior to second disbursement. Approval of a time-bound plan by the Pension Superintendence for the initiation of activities by PFA will be a condition prior to second disbursement. Approval of a time-bound plan by the Pension Superintendence to transfer eligible INSS contributors will be condition prior to second disbursement.*

#### IV. FINANCING AND EXECUTION

##### A. Financing

- 4.1 The total amount of the program will be US\$30 million of fast-disbursing resources to be disbursed according to the normal conditions of the Fund for Special Operations (FSO). The terms and conditions of the loan are provided below:

**Table 4.1**

Terms and Conditions	
Amount	IDB: US\$30 million
	Total Program: US\$30 million
Amortization period	40 years
Grace period	10 years
Disbursement period	18 months
Interest rate	1% p.a. first 10 years
	2% p.a. until final repayment of the loan
Inspection and Supervision	1%
Credit fee	0.5%

##### B. Disbursement schedule and conditions

- 4.2 The proposed operation will be disbursed in two consecutive disbursements, subject to compliance with the conditions presented in Section III C above and in the *Policy Matrix*, which will be included in the operation's loan contract. The first disbursement will be up to US\$20 million and the second up to US\$10 million. *Second disbursement is expected within six to nine months following Board approval.*

##### C. Borrower and executing agency

- 4.3 The Borrower of the resources will be the Republic of Nicaragua.
- 4.4 The Executing Agency of the program will be the Technical Secretariat of the Presidency of the Republic (*Secretaria Técnica de la Presidencia de la República*

– SETEC), which is the central coordinating entity within GON for social policy and has been in charge of coordinating the design and implementation of the pension reform program. SETEC will be responsible for presentation of all evidence of compliance with disbursement conditions.

**D. Disbursement procedures**

- 4.5 Fast-disbursing resources from the program will be used to finance - inter alia - the costs of eligible imports from the Bank's member countries. Funds shall be disbursed for Borrower's use upon request through presentation of evidence of compliance with all contractual conditions.
- 4.6 Ministry of Finance, in coordination with the SETEC, is responsible for maintaining appropriate accounting records. Loan resources shall be deposited in segregated accounts. The Bank will require the Borrower to maintain appropriate records of funds disbursed from the loan and reserves the right to require the borrower to furnish an audited report of disbursed funds.

**E. Inspection and supervision**

- 4.7 The Bank shall establish such inspection procedures, as it deems necessary to ensure satisfactory execution of the program. The Borrower shall cooperate fully in providing all assistance and information required for this purpose.

**F. Ex-post evaluation**

- 4.8 The Borrower has not indicated it will perform a formal ex-post evaluation of the program. However, the Bank may perform its own ex-post evaluation to determine compliance with program objectives. This evaluation would take place in coordination and with assistance from the corresponding evaluation units of the Bank, specifically in the definition of procedures and methodologies, and its costs would be born by the Bank.

**G. Environmental and social aspects**

- 4.9 The proposed program has no environmental impact, given that its activities are limited to legal and institutional reforms of Nicaragua's pension system. The social aspects of the proposed operation are judged positive, mainly because it will (a) contribute to eliminate a system with an inherently regressive income transfer element, (b) reduce labor market distortions, and disincentives for pension provision, which tend to be more pronounced in the semi-formal employment areas, and (c) provide a minimum pension coverage for low income contributors. The Committee on Environment and Social Impact approved the operation and its project document without observations April 6, 2001.
- 4.10 The operation qualifies as a social equity enhancing project , as described in the indicative targets mandated by the Bank's Eighth Replenishment (Document AB-

1704). The rationale for qualifying as SEQ is that the reform will eliminate the negative redistributive elements of the present system and establishes protection for the lower income contributor. The current system mainly serves a small fraction of comparatively well off employees, financing the accumulating pension obligations through increased fiscal transfers. Furthermore, the state guaranteed minimum Old Age, disability and survivor insurance protects especially lower-income contributors from a shortfall in the accumulated value of their individual funds. The project does not specify explicit performance indicators to measure poverty reduction and social equity enhancement.

## V. JUSTIFICATION AND RISKS

### A. Justification

- 5.1 The proposed operation would assist the Government of Nicaragua in implementing a far-reaching structural reform of the Pension System. The reform is aimed at replacing the current PAYG scheme with a mandatory private DC system thereby avoiding a further increased in the implicit fiscal costs of the present arrangement and subsequent macro economic distortions and inequalities.
- 5.2 Containing the fiscal costs of the public provision of pension benefits will eliminate inter- and intra-generation inequalities, including the income transfer toward the higher income segments of society, as well as strengthen the macro economic framework. The reform will reduce labor market distortion, in as much as it will provided for the sustainable financing of meaningful old age benefits for system participants. Private sector administration of the system, within the framework of adequate regulation, will increase its transparency and credibility, and the availability of long-term resources will contribute to the development of the domestic financial markets.
- 5.3 Fostering the economic safety of pensioners and assuring an adequate living standard in retirement, without having to rely on the state for supplemental assistance is the main expected benefit of the reform. Increasing the coverage rate of the system, therefore, will be one of the major challenges faced by the new system, especially with regard to first time employees, self-employed and the rural work force. Nevertheless, no specific incentives for any particular work-force group are contemplated at present in the program or through parallel measures to induce their affiliation, but it is assumed that the general alignment of incentives in the new system will provide sufficient inducement for all employees to affiliate themselves. The assumption is sustained by the experience with recent reforms in comparable countries, El Salvador and Bolivia, where a substantial increase in the coverage rate could be observed over time.<sup>34</sup> However, increased coverage of self-employed has proven somewhat more elusive in all reform cases, partially given the perceived higher returns of investment of alternative fund use for this sector.
- 5.4 While in the short-run the parametric reform may cause some detrimental effects on employment, the creation of a fully funded defined contribution scheme will reduce labor market distortions and promote the creation of new employment opportunities. The parametric reform is tantamount to an increase in labor taxes by five percentage points, which according to some studies, may reduce

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<sup>34</sup> El Salvador initiated private pension coverage in April 1998, retaining the public system as an option for certain affiliates. Between December 1998 and February 2000 the number of affiliates in both systems increased by over 200,000 employees to a total of approximately 838,000, equivalent to 31.6% of PEA. Over 90% of all affiliates were affiliated with private pension providers, with 20% representing voluntary affiliations.

employment between 1% and 3% for those workers that remain in the old system. However, for workers 43 years and younger and for those who enroll in the new system as first time affiliates, labor taxes should decline due to the tighter connection between contributions and benefits in an individual account system, raising employment within these group of workers.

- 5.5 Although the operation's resources are small compared to the eventual fiscal requirements of the reform, Bank involvement will lend added credibility to the process and the provision of Balance of Payment support will contribute to strengthen the macro economic framework, creating a conducive environment for the reform.

## **B. Risks**

- 5.6 The proposed operation by itself does not face major risks for its execution and the disbursement of resources. A broad social consensus regarding the reform has been established, with all sectors agreeing on its importance and main elements. Moreover, Government and Parliament have moved decisively in approving the required legal framework for the DC system and the parametric reforms have been enacted. The remaining legislation does not appear to be conflictive and the implementation process follows agreed-upon technical criteria. Nevertheless, presidential and parliament elections in the fall of 2001 and accompanying uncertainty could influence the speed of implementation of the system.
- 5.7 The successful implementation of the reform, nevertheless, and therefore the long-term success of the operation, does face risks. First and foremost, successful reform implementation will need to overcome a legacy of "absenteeism" with regard to the social security system in general and pension provision in particular. While the reform initially will cover a captive market, the challenge and success will need to be measured by the expansion of the current very low coverage rate. Creation of a stable macro economic framework, the broad social consensus regarding the reform, an expansive education and publicity campaign and increased enforcement actions are elements aimed to mitigate the risk. Furthermore, the linkage of contribution and benefits in a direct fashion through individually controlled accounts, as well as the private management of the system should reduce the "taxation perception" of the current system and provide added incentives for affiliation and contribution.
- 5.8 Increasing the coverage rate through increased public awareness and improved enforcement will help to increase the volume of total pension funds under administration and thereby increase the market's attractiveness for potential PFA investors. Moreover, the outsourcing possibilities provided by the pension legislation should further allow reducing the costs of setting-up operations and thereby the risks posed to the successful reform implementation by Nicaragua's comparatively small market. In this context, the presence of important international investors in neighboring countries and interest expressed by those and domestic capital in establishing PFA bodes well for the reform.



- 5.9 However, a potentially low level of competition constitutes one of the major challenges for the implementation of the reform. As has been observed in all reform countries, the need to reach economies of scale usually drives a consolidation process after a couple of years of system operations, significantly reducing the number of PFA; e.g. El Salvador and Chile. Although the legal and regulatory framework of the Nicaraguan pension system reduces the potential for abusive market behavior, through no-discrimination rules, caps on commissions and minimum service standards, authorities will need to be mindful of the potential adverse effect of consolidation on competition. Furthermore, given that at the systems' start a significant captive market can be captured, authorities will need to create a level playing field for all initial providers.
- 5.10 A second market risk results from the relatively incipient development of Nicaragua's financial sector, both in terms of depth and institutional strength. Bank deposits and Government debt are the dominating investment options, followed by a very limited supply of private debt. The shallowness of the capital market is further evidenced by the importance of option/repurchasing operations in overall trading volume. Lack of market depth could affect the diversification options for PFA and the resulting risk profile. GON intends to mitigate those risks by allowing PFA from the outset to invest a significant portion of funds in the international capital markets.

## 1. Carta de Política

### *Programa de Reforma del Sistema de Pensiones*

*Managua 15 de mayo del 2001*

(i)  
SETEC-E-1202-05-01

*Estimado Señor Presidente:*

*Nuestro Gobierno asumió sus funciones en enero de 1997 con el firme propósito de continuar profundizando la democracia y la modernización del país dentro del marco de una economía de mercado abierta y competitiva. Para facilitar este proceso de transición el Gobierno de Nicaragua en marzo de 1998 formalizó un acuerdo de tres años con el Fondo Monetario Internacional bajo la Facilidad Ampliada de Ajuste Estructural (ESAF) y posteriormente la Facilidad de Reducción de Pobreza y Crecimiento (PRGF), el que contempla tanto medidas de estabilización, como reformas estructurales. Entre otros, se acordó la reducción del déficit fiscal, el aumento de las reservas internacionales y medidas estructurales que permitan incrementar la participación de la empresa privada en la economía nacional.*

*Dentro de este programa el Gobierno de Nicaragua ha incluido, como una de sus prioridades, la Reforma del Sistema de Pensiones para el seguro de Invalidez Vejez y Muerte (IVM). Esta reforma consiste fundamentalmente en cambiar el sistema actual de reparto (PAYG) que ofrece un beneficio definido por un nuevo sistema totalmente financiado de contribuciones definidas basado en cuentas de capitalización individual manejado por empresas administradoras de fondos de pensiones (AFP).*

*La reforma permitirá establecer un sistema de pensiones financieramente sostenible, transparente en la relación aporte-beneficio y de carácter privado. Con la reforma se reducirá el costo fiscal del sistema actual, contribuyendo a mantener la estabilidad macro económica en el largo plazo. Asimismo, se reducirán las distorsiones en el mercado laboral y en la redistribución de ingresos, beneficiando a los sectores de menores ingresos. Por ende, la reforma contribuirá a dinamizar los mercados financieros a través de la mayor oferta de recursos de largo plazo y al desarrollo del mercado de capitales y de seguros.*

(b) Características del Sistema de Reparto Antes de la Reforma Paramétrica del 2000

*El sistema actual de pensiones de IVM corresponde a un sistema de reparto de beneficio definido administrado por el sector público. Las contribuciones al sistema de IVM son obligatorias para los trabajadores asalariados y voluntarias para los trabajadores independientes. Un trabajador debe cotizar durante un mínimo de 750 semanas (15 años) y cumplir 60 años para tener derecho a percibir una pensión que se calcula sobre la base del salario semanal promedio de las últimas 250 semanas (5 años) de trabajo. La tasa de reemplazo de las pensiones es el 40% del salario base, más el 1.365 % acumulativo para cada año después de los primeros 3 años.*

El sistema actual tiene 320,000 afiliados y la cotización para las tres ramas, que comprende salud, IVM y riesgos profesionales antes de la Reforma Paramétrica del 2000 consistía en una tasa de cotización del 17%, correspondiendo el 8.5% a salud, 5.5% a la rama de IVM, 1.5% a riesgos profesionales y 1.5% para las pensiones de víctimas de guerra. En el año 2000 la tasa de cotización para la rama de IVM se incrementó a 10% pasando el total para las tres ramas a 21.5%. Las pensiones que se pagan actualmente corresponden a 100,000 personas, de las cuales aproximadamente 40,000 corresponden a víctimas de guerra.

*El nivel actual de pensiones que se pagan tanto contributivas como no contributivas es muy superior a lo que es sostenible actuarialmente, existiendo un desequilibrio entre el nivel de las contribuciones y el nivel de los beneficios. Los cálculos actuariales reflejan un saldo corriente negativo para 1999 de 80 millones de córdobas (US\$7 millones), que corresponden al 0.8% del PIB. De continuar ésta tendencia del actual sistema, el Gobierno debería cubrir los déficit futuros los cuales representarían en el mediano plazo aproximadamente el 10% del PIB.*

**(i) Fundamentos para la Reforma**

En el largo plazo la situación financiera se deteriora aún más. El déficit del sistema crecería rápidamente con repercusiones sociales adversas. Las reservas del sistema actual se agotarían en el futuro inmediato y su coeficiente de dependencia (el número de beneficiarios por cada trabajador activo) aumentará de 11.2% en 1996 a 27% en el 2030. Al mismo tiempo, la deuda implícita del Sistema de Pensiones actual, valor presente de las pensiones actuales más las pensiones de los futuros jubilados pasaría del 85% del PIB en 1996 a más del 400% en el año 2030.

*El sistema de pensiones actual no es sostenible debido al desequilibrio entre contribuciones y beneficios, sus elevados costos administrativos debido al tamaño del sistema y las altas tasas de evasión. El sistema tampoco es atractivo para los trabajadores porque a pesar del desequilibrio entre contribuciones y beneficios las pensiones que reciben los trabajadores son muy bajas, el sistema perpetúa las desigualdades intrageneracionales. El sistema no permite que los trabajadores desarrollen un sentido de propiedad sobre sus ahorros y por lo tanto perciben sus contribuciones como un impuesto y además el sistema es ineficiente en cuanto a manejo de las inversiones, cálculo de las pensiones y pago de beneficios.*

*Además el actual sistema de pensiones presenta claros elementos de inequidad, principalmente en contra de los trabajadores de más bajos ingresos. Aún cuando un asegurado haya cotizado durante la mayor parte de su vida laboral, pero no mantiene un empleo formal, a los 60 años, difícilmente obtendrá derecho a una pensión por no cumplir con los requisitos exigidos. Asimismo, el sistema actual no incentiva la participación de trabajadores independientes.*

## **Estrategia y plan para la reforma del sistema de pensiones**

*La estrategia para la reforma del sistema de pensiones está diseñada para evitar la quiebra del actual sistema de reparto; para que los futuros jubilados en el nuevo sistema de pensiones reciban una pensión de acuerdo a sus contribuciones, las cuales serán mayores a las actuales pensiones; para acoger a todos los sectores de la economía nacional, incluyendo los trabajadores independientes y a los del sector informal; para la capitalización individual de los ahorros de cada contribuyente; para la administración de los fondos por entidades de giro único como son las administradoras de fondos de pensiones (AFP); para la optimización de las inversiones de los fondos de pensiones para obtener una buena rentabilidad; para una adecuada y estricta fiscalización de los fondos a través de la Superintendencia de Pensiones.*

*Para lograr lo anterior desde inicios de 1998 se creó una comisión interministerial formada por el Ministro de Hacienda y Crédito Público, el Presidente del Banco Central, el Presidente Ejecutivo del INSS y el Secretario Técnico de la Presidencia que la preside. La comisión interministerial se apoya en el Comité para la Reforma del Sistema de pensiones (CREPEN), formado por un conjunto de profesionales altamente preparados, esta comisión elaboró los estudios y alternativas de reformas y continúa en el proceso de implementación.*

*La reforma al sistema de pensiones aprobada por el comité interministerial se hizo después de considerar diferentes alternativas que contemplaban el aumento en las tasas de cotización, cambios en la edad de jubilación, el costo de transición, el período para acceder a la pensión de jubilación, el cálculo de la tasa de reemplazo, la factibilidad de la implementación, el análisis del marco legal actual, las leyes y reglamentos requeridos para su implementación y la organización y funcionamiento del nuevo sistema a ser administrado por las AFP y del actual sistema a ser administrado por el INSS.*

## **Nuevo sistema de pensiones**

El nuevo sistema de pensiones aprobado en abril del 2000, es obligatorio para los trabajadores dependientes y voluntario para los trabajadores independientes, es un sistema basado en cuentas de capitalización individual que serán administradas por las AFP.

*Los contribuyentes actuales menores de 43 años se pasarán al nuevo sistema, así como todos los trabajadores que se afilien al sistema posteriormente independientemente de su edad, en tanto que los contribuyentes mayores de 43 años se quedarán en el sistema actual. El nuevo sistema de pensiones contempla cambios paramétricos en las tasas de cotización,*

*años requeridos para la jubilación y lo concerniente a la edad de jubilación, en el caso de la pensión mínima ésta estará garantizada por el Estado. Asimismo, a los afiliados que se pasarán al nuevo sistema de pensiones se les reconocerán sus aportes efectuados al régimen de reparto mediante Certificados de Traspasos, los que se harán efectivos al momento de hacer efectivo los derechos de beneficios del afiliado o sus sobrevivientes. Los fondos de la capitalización individual, que son los ahorros de los contribuyentes serán invertidos en títulos nacionales y extranjeros con el objetivo de obtener la máxima rentabilidad observando al mismo tiempo factores adecuados de seguridad. Estos títulos*

*deberán ser aprobados por la Comisión de Riesgos e invertidos en portafolios de inversión de acuerdo a los rangos establecidos en la Ley del Sistema de Ahorro para pensiones con el objetivo de diversificar el riesgo y lograr una mayor rentabilidad.*

*Se creará la Superintendencia de Pensiones para fiscalizar el funcionamiento de las AFP, las operaciones de los recursos de los fondos de inversión, la composición de la cartera y el otorgamiento de las prestaciones que éstas otorguen a sus afiliados.*

### **Implantación del nuevo sistema de pensiones**

*En marzo de 2000 la Asamblea Nacional aprobó la Ley del Sistema de Ahorro para Pensiones, Ley 340, que establece las bases legales del nuevo sistema de pensiones. Posteriormente el Ejecutivo aprobó las reglamentaciones de la Ley, específicamente el Reglamento General, el Reglamento de Inversiones, el Reglamento del Certificado de Traspaso y el Reglamento de Comisión Calificadora de Invalidez, que facilitarán su implantación.*

*En marzo 2001 la Asamblea Nacional aprobó la Ley Orgánica de la Superintendencia de Pensiones, Ley 388, que establece las bases legales para la supervisión y regulación del nuevo sistema de pensiones y crea la Superintendencia de Pensiones como órgano autónomo rector del sistema.*

Como siguiente paso en su estrategia de implantación del nuevo sistema de pensiones el Gobierno de Nicaragua desarrollará sus bases institucionales, especialmente en lo que se refiere a la constitución de una Superintendencia de Pensiones eficaz y el complemento de las normas operativas del sistema. En este sentido, se avanzará en la conformación de las estructuras de dirección y administración de la Superintendencia, a través del nombramiento de su Consejo Directivo y del Superintendente, así como la conformación de los cuadros técnicos y la implantación de las normas y procedimientos que permitirán el funcionamiento de la institución. El establecimiento de la Superintendencia de Pensiones se complementará con la definición de normas sobre el funcionamiento del sistema, especialmente en lo que se refiere a la autorización de las AFP y el traslado de contribuyentes del sistema antiguo al sistema nuevo.

Todo lo anterior creará las bases para la autorización de las AFP y el inicio efectivo de actividades del nuevo sistema, lo que se espera para el segundo semestre del presente año. El Gobierno procederá con un proceso de máxima transparencia e igualdad de oportunidades para todos los inversionistas interesados y de acuerdo a lo establecido en la Ley 340 se espera autorizar al menos dos AFP en un inicio, lo que garantizaría un mínimo nivel de competencia en el sector y de posibilidad de selección para los afiliados.

La implantación del nuevo sistema permitirá ampliar la cobertura de afiliados significativamente, tal como muestra la experiencia en los países hemisféricos que han llevado a cabo reformas similares. Ellos han experimentado especialmente una creciente incorporación de sectores de menores ingresos y de auto empleo a los sistemas de pensiones, dándole un claro sentido social y de equidad a las reformas. Asimismo, la reforma se convertirá en un catalizador de desarrollo de los mercados financieros y de capital del país, tanto a través de la generación de ahorros internos de largo plazo, como

la continua modernización de las empresas financieras privadas, a cargo de la administración del sistema.

*La implantación de la reforma conlleva al reconocimiento de costos de transición para el sector público ya que éste deja de percibir las cotizaciones de los contribuyentes que emigran al nuevo sistema a la par que continúan haciéndole frente a las obligaciones de los asegurados. Actualmente, el Gobierno de Nicaragua está evaluando distintas modalidades de financiar estos costos minimizando cualquier impacto en los segmentos de menor ingreso del país.*

### **Conclusión**

Desde el inicio de la década de los 1990 Nicaragua ha progresado significativamente en el proceso de estabilización económica y de reforma estructural, estableciendo las bases de una economía competitiva y abierta, con una alta participación de la iniciativa privada en todos los sectores. El actual Gobierno ha avanzado decididamente en este sentido teniendo como prioridad reducir la desigualdad y pobreza en el país. La inclusión de Nicaragua en la iniciativa HIPC es expresión y fruto de este esfuerzo. La reforma del sistema de pensiones y la asistencia solicitada al Banco Interamericano de Desarrollo dentro del Programa de Apoyo a la Reforma del Sistema de Pensiones contribuirá al avance de la modernización del estado en Nicaragua.

Sin más a que referirme, aprovecho la oportunidad para reiterarle las muestras de mi más alta y distinguida consideración.

*Muy atentamente,*

(2)

PRESIDENCIA DE LA REPUBLICA  
SECRETARIO TECNICO

(3)

(4) *Señor*

**B. Enrique V. Iglesias**

*Presidente*

*Banco Interamericano de Desarrollo*

Washington, D.C.

*cc: Ing. Esteban Duque Estrada, Ministro de Hacienda y Crédito Público*  
*Dr. Noel Ramírez S., Presidente Banco Central de Nicaragua*

(a) **Lic. Martín Aguado, Presidente**  
**Ejecutivo, INSS**

**Matrix for Disbursement Conditions**  
**Support of the Pension System Reform**  
**Nicaragua NI-0101**

Reform Area	Objective	Prior to Presentation	2 <sup>nd</sup> Disbursement	Means of Verification
Macro-Economic Framework	Facilitate the implementation of the policy reforms through adequate macroeconomic policies	Maintain a <i>macroeconomic policy framework consistent</i> with program objectives	Maintain a <i>macroeconomic policy framework consistent</i> with program objectives	Assessment of the IDB, in coordination with the IMF
Legal Framework	Establish an appropriate legal framework for the defined contribution system	<p>Approve and enact satisfactory <i>Pension Law</i>.</p> <p>Executive approves and enacts satisfactory <i>implementing regulation</i> (reglamentos) for the Pension Law:  Reglamento General  Reglamento de Inversión  Reglamento de Certificado de Traspaso  Reglamento de Inversiones en el Extranjero</p>		<p>Parliament approval of legislation and publication in <i>La Gaceta</i><sup>1)</sup>.</p> <p>Publication in <i>La Gaceta</i><sup>1)</sup></p>
	Establish an appropriate legal framework for supervision of pension system	<p>Approve and enact a satisfactory <i>Pension Superintendence Law</i></p>	Executive approves and enacts satisfactory <i>General implementing regulation</i> (reglamento general) for the Pension Superintendence	<p>Parliament approval of legislation and publication in <i>La Gaceta</i><sup>1)</sup>.</p> <p>Publication in <i>La Gaceta</i><sup>1)</sup></p>



			<p>Law, which will include:</p> <ul style="list-style-type: none"> <li>(i) procedures to select and replace Board members</li> <li>(ii) definition of Board functions and rules</li> <li>(iii) definition of violations and sanctions regime</li> <li>(iv) conflict of interest rules for INSS participation in Superintendence Board</li> </ul>	
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Parametric Reform	Reduce fiscal costs of PAYG during transition	Adjust contribution rate of PAYG system		Publication in <i>La Gaceta</i> <sup>1)</sup> of legal instrument establishing adjustment
Institutional Framework	Create the basic institutional structure to allow implementation of the system and its supervision.		<p>Pension Superintendence is operational:</p> <ul style="list-style-type: none"> <li>(i) Superintendent appointed</li> <li>(ii) Superintendence Board appointed</li> <li>(iii) Budget established and resources allocated for first year of operations</li> <li>(iv) Adequate staff contracted to initiate operations</li> <li>(v) Operative and administrative procedures and manuals approved</li> <li>(vi) Design of reporting and information systems</li> </ul>	<p>Certified documentary evidence (i) – (iv).</p> <p>Resolution Pension Superintendence Board (v) – (vii)</p>

Regulatory Framework	Provide the basic regulatory arrangements to facilitate adequate system implementation and operation		<p>(vii) Ethic rules for staff approved</p> <p>Initial System norms are issued by the Pension Superintendence:</p> <p>(i) Eligibility and licensing of PFA</p> <p>(ii) Affiliation of INSS contributors</p> <p>(iii) Affiliation of new contributors</p> <p>(iv) Risk classification and rating of investments</p> <p>(v) Related party investments</p> <p>(vi) Collection and transfer of contributions</p> <p>(vii) Chart of account</p>	Approval by Pension Superintendence Board or Superintendent, publication and effectiveness; certified documentary evidence.
Financing	Determine fiscal costs of reform and identify financing sources.		Assess the long-term fiscal costs of the reform, including the costs of minimum pensions under the new system	Presentation of actuarial assessment

			Develop and approve satisfactory financing plan.	Approval financing plan by the Inter-Ministerial Committee for the Reform of the Pension System
Implementation of System	Initiate the operation of the new pension system		<p>Determination of the contribution histories of all INSS affiliates to be transferred to PFA</p> <p>Approval of rules for calculation of</p>	<p>Certification by Pension Superintendence and sample review by INSS external auditor.</p> <p>Approval by Pension Superintendence</p>

			<p>calculation of recognition bonds' value and their transfer into custody of PFA</p> <p>Evaluation and selection process has been completed and two or more Pension Fund Administrators have been licensed</p> <p>Establish time-bound plan for initiation of activities by PFA</p> <p>Establish time-bound plan for transfer of eligible INSS contributors.</p>	<p>Superintendence</p> <p>Resolution and publication by Pension Superintendence of licensing of PFA, according Art. 125, Law 340</p> <p>Agreed-upon plan ratified by Pension Superintendence</p> <p>Agreed-upon plan ratified by Pension Superintendence.</p>
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<sup>1)</sup> Official Newspaper